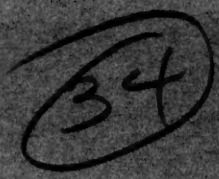

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No. 195

In the Supreme Court of the United States

OCTOBER TERM, 1942

AMERICAN LIBERTY OIL COMPANY, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 62–73) is reported at 43 B. T. A. 76. The opinion of the Circuit Court of Appeals for the Fifth Circuit (R. 192–195) is reported at 127 F. (2d) 262.

JURISDICTION

The judgment of the circuit court of appeals was entered April 3, 1942 (R. 196). The petition for writ of certiorari was filed July 1, 1942. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Where taxpayer sold producing leaseholds, together with the appurtenant equipment, but retained a specified interest in the oil, should the cost basis of the leaseholds be allocated between the part sold and the part reserved, in proportion to the respective values of the interest sold and the interest retained?

2. In 1934 the taxpayer committed a breach of a contract to supply oil, and in 1936 agreed to pay and paid the other party to the contract $120,000 in settlement of that party's claim. May the taxpayer take a deduction from its 1934 income on account of the payment made in 1936?

STATUTES AND REGULATIONS INVOLVED

Revenue Act of 1934, c. 277, 48 Stat. 680:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> (a) *Expenses.* — All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, * * *
>
> * * * * * *
>
> SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.
>
> (a) *Computation of Gain or Loss.*—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain, and the loss shall be the excess of the

adjusted basis provided in such section for determining loss over the amount realized.

* * * * *

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; * * *

* * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined under subsection (a), adjusted as hereinafter provided.

* * * * *

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

* * * * *

(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under

section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

ART. 22 (a)–11. *Sale of real property in lots.*—If a tract of land is purchased with a view to dividing it into lots or parcels of ground to be sold as such, the cost or other basis shall be equitably apportioned to the several lots or parcels and made a matter of record on the books of the taxpayer, to the end that any gain derived from the sale of any such lots or parcels which constitutes taxable income may be returned as income for the year in which the sale is made. This rule contemplates that there will be gain or loss on every lot or parcel sold, and not that the capital in the entire tract may be recovered before any taxable income shall be returned. The sale of each lot or parcel will be treated as a separate transaction, and gain or loss computed accordingly.

STATEMENT

The pertinent facts, as found by the Board of Tax Appeals, may be summarized as follows:

Facts with respect to the allocation of the cost of the leases.

On January 1, 1934, taxpayer owned certain leasehold interests in oil and gas producing properties and the lease and well equipment thereon. Its interests in the oil reserves, as estimated by the

Commissioner, amounted to 19,295,522 barrels as of that date. Between that date and April 18, 1934, 205,919 barrels were extracted so that an estimated 19,089,603 barrels remained. (R. 60, 110.)

On April 18, 1934, taxpayer sold these leasehold interests together with the equipment for a cash price of $1,500,000. It excepted from the sale, however, 4,400,000 barrels of oil when, as, and if produced, less certain amounts to be paid to third parties in accordance with contracts previously made by the taxpayer. (R. 60, 116–161.) The fair market value of this reserved oil interest was not less than $1,596,804.41 (R. 60, 110).

The cost of the leaseholds, less depreciation allowed or allowable as of the date of the sale, was $946,828.01. The depreciated cost of the equipment was $648,134.05. The costs incurred by taxpayer in connection with the sale for legal expenses, commissions and abstracts of title amounted to $19,149.96. (R. 60–61, 111.)

The Board of Tax Appeals and the court below held that the profit which taxpayer realized from the sale should be determined in two steps: first, the cost basis for the leaseholds should be allocated between the oil interests sold and the oil interest reserved in proportion to the respective values of such interests at the date of sale; second, from the cash consideration (which was paid for the oil interest sold plus the equipment) there should be deducted the sum of (a) the portion of the total

cost allocated to the oil interest sold, (b) the expenses of the sale, and (c) the depreciated cost of the equipment.[1]

Facts with respect to taxpayer's breach of contract in 1934 and settlement for $120,000 in 1936.

The foregoing sale of taxpayer's properties disabled it from performing a written but unrecorded contract (Ex. 2, R. 177–179) to sell and deliver to the pipe lines of the Tyler Pipe Line Company such amounts of oil produced from the taxpayer's so-called Golding–Murchison properties as the Tyler Company might desire to purchase (R. 62). Negotiations with the Tyler Company to determine the extent of taxpayer's liability on account of

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[1] The following is a computation of the taxpayer's income in 1934 from the sale, made in accordance with the findings and opinion of the Board (cf. R. 79–80):

Fair market value of all properties at date of sale:		
Cash	$1,500,000.00	
Value of oil payment reserved (stipulated)	1,596,804.41	
		$3,096,804.41
Less: equipment		648,134.05
Value of all oil rights		2,448,670.36
Value of oil rights sold:		
Cash selling price	$1,500,000.00	
Less: cost of equipment	648,134.05	
		851,865.95
Value of oil rights retained (i. e., 4,400,000 barrels less payments to third persons)		1,596,804.41
Cost of leasehold interest sold: $\frac{\$851,865.95}{\$2,448,670.36} \times \$946,828.01 =$		329,391.05
		617,436.96)
(Cost of oil rights retained		
Cash received on sale		1,500,000.00
Less:		
Cost of leasehold interest sold	$329,391.05	
Equipment	648,134.05	
Expense of sale	19,149.96	
		996,675.06
Correct profit on sale		$503,324.94

the breach of the contract had commenced even prior to the sale and they continued until April 1, 1936 (R. 63). On that date the Tyler Company discharged taxpayer from its obligation under the contract for a consideration of $120,000 (see release, Ex. 3, R. 179–182). On June 30, 1936, the amount of the payment was entered on the books of taxpayer in an account entitled "Sale of Leases—Atlantic" (see R. 182–A). On December 31, 1936, the item was transferred to an account styled "Earned Surplus—Unappropriated 1934" (R. 63, 185).

The court below affirmed the decision of the Board of Tax Appeals holding that the $120,000 payment was not deductible from taxpayer's gross income for the year 1934 (R. 60–65, 194–195).

ARGUMENT

1. The taxpayer sold a part of its interest in oil properties and retained a part. As to the reserved interest in the oil, taxpayer will be entitled to depletion deductions as and when such oil is produced. *Palmer* v. *Bender,* 287 U. S. 551; *Thomas* v. *Perkins,* 301 U. S. 655. Accordingly, it would secure a double deduction for the same capital investment if it prevailed in its present attempt to deduct the entire cost of the leaseholds from the price received for the part sold. The court below properly concluded (R. 194) that the cost of the leaseholds must be allocated between the part sold and the part retained in proportion to the respective values of each.

It was also correct to allocate the total cost in the proportion which the value of the interest sold bore to the value of the interest retained. The taxpayer's contention that the allocation should be made in the proportion of the estimated number of barrels sold to the number of barrels retained, disregards two essential facts. The first is that the reserved interest was to be drawn from a substantial proportion of the first oil produced (R. 118–119) so that the value of each of the barrels reserved was far greater than the more speculative value of the last of the barrels which the field was estimated to contain. Second, the reserved interest was to bear none of the costs of operation, another factor giving it a greater value than the comparative volumes alone would indicate.

Taxpayer alleges as the principal reason for granting the writ that the decision below conflicts with *Burnet* v. *Logan,* 283 U. S. 404, on the question of whether any apportionment should be made (Pet. 5). There is no conflict. In *Burnet* v. *Logan,* it appeared that the taxpayer in 1916 had sold all of certain stock for a cash consideration plus a promise to make future payments for each ton of ore received from a certain mine. The Commissioner, treating the capital transaction as closed in 1916, valued the contingent promise, and sought to allocate a pro rata portion of the cost basis to each of the recurrent payments, treating the excess as income, though the cash consideration, plus the sum of the actual payments, was less than the cost basis of the stock. The Court pointed

out that the taxpayer did not realize either a return of capital or income upon mere receipt of the contingent promise, and held that no part of the future payments was taxable as income until the sum of the payments received exceeded the basis of the stock. But in the present case, no effort was made to tax the taxpayer as if it had received contingent future payments. In the present case the taxpayer retained a part interest in the property and the sole question is whether there should be an allocation of the cost basis of the property between the part retained and the part sold, so as to determine fairly the gain on the part sold. It is true that the allocation requires a valuation of the right to 4,400,000 barrels of oil when, as, and if produced. But this is in no way contrary to *Burnet* v. *Logan*. In that case the Court pointed out that the contingent promise could be valued where necessary, as, for example, for purposes of the federal estate tax. So here it is proper to value the oil interest retained, even though contingent, in order to determine the taxpayer's gain upon the closed sale of the other part of the property.

The court below followed its decisions in *Columbia Oil & Gas Co.* v. *Commissioner*, 118 F. (2d) 459, and *Commissioner* v. *Roeser & Pendleton*, 118 F. (2d) 462.[2] There is no authority to the contrary.

[2] In the latter case a petition for certiorari raising other questions was denied, 314 U. S. 635.

2. The second question presented depends upon the application of settled principles of accounting to disputed facts. Under Point 3 of its brief (Br. 14–16) the taxpayer, which was on the accrual basis, asserts that the evidence clearly showed an admission of liability for breach of contract in 1934, and upon that basis argues that since the only uncertainty was with respect to the amount of the settlement to be made, the deduction should have been allowed in 1934. The Board determined, however (R. 63), that the proof did not establish that in 1934 taxpayer admitted to any liability beyond that for a technical breach of contract. Thus, the taxpayer is seeking to present an issue arising only upon a view of the facts with which both the Board and the court below have disagreed. The issue presents no basis for the issuance of the writ.

CONCLUSION

The decision below is correct. There is no conflict of authorities. The petition should be denied.

Respectfully submitted,

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